Local currency bond markets and its benefits for financial stability

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Overview

• Macroeconomic pre-conditions and objectives

• Current stage of development

• Lessons to be drawn from financial crisis

• French G20 Presidency and challenges ahead
I. Macroeconomic pre-conditions
Macroeconomic pre-conditions

Stability
- Macroeconomic stability is the first priority for developing local currency bond markets and for creating an investor friendly climate
- Price stability - main pre-condition to overcome „original sin“ and to reduce currency and maturity mismatches
- To develop a yield curve over the whole spectrum of maturities
- To reduce dependency on short term foreign borrowing
- Promotes issuance of longer term bonds with fixed nominal interest rates
- To reduce volatility of interest rates etc.

Credibility
- History matters, anchoring of inflation expectations
- Constrain volatility of interest rates, influence the level and volatility of the yield curve
- Enhance intermediation and marketisation of finance
- Credibility by strong laws, investor protection and efficient regulation
- Promote development of pension funds; enable pension funds to diversify investments
- Safety of investment environment
Transparency

- Empirical studies show that transparency enhances the broadening of the investor base, in particular promotes the entry of foreign investors.
- Transparency with regard to macroeconomic policy actions, transparency of market developments, issuance, and market structures.
- Ratings: according to empirical studies, surprisingly, around 90% of rating changes in emerging markets (EMEs) are determined by three global factors; no more influence of country-specific developments? Ratings: local, regional or global?
- Price and cost transparency, also with regard to payment and settlement.

Openness

- Sustained deepening of local currency bond markets (LCBM) needs a solid foreign investor base.
- Capital controls are a significant determinant for underdeveloped LCBMs.
- A well-balanced sequencing of capital account liberalisation and developing LCBMs is a key challenge.
- But more influence of global factors on interest rate and spread variance; 50% of the variance of the spreads in selected EMEs are determined by global factors.
- More dependent on international investor sentiment.
Local currency bond markets cannot be evaluated in isolation

Financial and economic structure

In a market economic system, development of local currency bond markets competes with

- … the banking system (for example decentralised banking system and asymmetric information; EM Europe high concentration of foreign banks – to what extent an obstacle for LCBM; import of currency and maturity mismatches)

- … international financial markets

- is dependent on the economic structure (size of firms, export structure etc.)

- … is in particular driven by (relative) transaction costs and differences in the regulatory framework
Macroeconomic pre-conditions

Financial Stability

- Financial stability and local currency bond markets can re-enforce each other

- Enhancing national and global financial stability and promoting economic growth are the main objectives of developing and deepening – i.e. enhancing liquidity - local currency bond markets

- How can local currency bond markets enhance financial stability?

- What are more traditional arguments and what are the lessons from financial crisis?
Benefits of developed local currency bond markets for financial stability – traditional arguments

- Enables reducing currency and maturity mismatches
- Better absorption of external shocks
  - Sudden stops, short-term reversals of international capital flows
- Facilitate the management of current account liberalization
- Strengthening economic growth
- But what are main criteria for successful “weathering” of financial crisis?
What benefits has been highlighted by the current financial crisis?

• Help constrain systemic risks

• Provide a spare tyre for refinancing
  
  “In some countries … there was some continued issuance of local bonds. This is consistent with the view that local capital markets may have to some extent acted as a ´spare tyre` during the crisis, reducing vulnerabilities to declines in international bond finance […].” – BIS, Quarterly Review, June 2009, p 57Jaime Caruana, /2009,

• Support global rebalancing of growth
  
  Eswar S. Prasad, Rebalancing Growth in Asia, NBER Working Paper Series, July 2009, No 15169

  ➢ Underdeveloped financial markets – capital flows “up hill”
  
  “In line with literature summarised above, econometric analysis has also supported the idea that underdevelopment (of financial markets) in emerging economies has been one structural factor contributing to the accumulation of global imbalances and, in particular, to the phenomenon of net capital flowing “uphill” from LICs to HICs.” (ECB Monthly Bulletin, October 2009)
What benefits has been highlighted by the current financial crisis?

• Help to constrain spill over effects into the real economy

• Broadens the spectrum for fiscal policy measures in times of financial crisis

• Countries with developed bond markets have less volatility in capital flows
  (IMF;GFSR) – But what about volatility of domestic markets?

• Contributes to constrain asset inflation

  „Moreover, the lack of alternative financing mechanisms such as a deep corporate bond market has led firms to retain their earnings in order to finance future investment projects.“ (p 14) Prasad (2009)
II. Current stage of market development
Dynamic growth of domestic debt outstanding

Domestic Debt Outstanding in EME
US $ trillion

EM Asia  EM Latin America  EM Europe  EM Sub-Saharan Africa
Growth not much influenced by financial crisis
Risk Premiums on Emerging Market Economies' Sovereign Debt Instruments*

Source: J.P. Morgan. — * J.P. Morgan Emerging Market Bond Index includes bank loans, Brady bonds and international bonds; spreads over US Treasuries.
EM Corporate risk premium tripled against 2007 level
Corporate bond markets remain underdeveloped
¾ of all domestic debt securities are concentrated in only 5 countries

Concentration of the volume of domestic debt securities outstanding in emerging market economies
End-September 2010

- China: 34%
- Brazil: 15%
- South Korea: 13%
- India: 8%
- Mexico: 5%
- Turkey: 3%
- Taiwan: 2%
- Other issuers: 20%

Source: BIS and own calculations.
„Spare tyre“ argument is valid – but consider the low level
German holders of Local Currency Bonds in selected EMEs – in Euro, end 2010

The data are taken from the Deutsche Bundesbank’s securities deposit statistics. However, these list only such debt securities as are held in custody by German custodians. These are investments by monetary financial institutions, investment funds, insurance corporations and pension funds.
III. Lessons from financial crisis
Lessons to be drawn from financial crisis

Is there a need for extending existing recommendations?

- One point of reference – recommendations of the G8 Action Plan
  - Strengthening market infrastructure and debt management
  - Diversifying the investor base
  - Developing derivatives and swap markets
  - Broadening the date base
  - Regional cooperation
  - Developing local currency bond markets in developing countries, in particular Sub-Saharan African Countries
  - Enhancing technical assistance
Lessons to be drawn from financial crisis

But financial crisis has re-enforced following priorities

- Macroeconomic liquidity not sufficient; outflow of liquidity by foreign investors was not sufficiently substituted by domestic investors
- Broadening the investor base remains a priority
- Same is true for closing data gaps
- To what extent, regulatory deficits are an obstacle for the development of corporate bond markets in EMEs?
- How clearing and settlement systems worked during the crisis; still significantly fragmented.
Lessons to be drawn from financial crisis

• How to tackle short-term portfolio flows, which in particular prove a destabilising factor?

• There is no sufficient differentiation between fundamentals of the EMEs by international investors before and during the crisis – this empirical result is valid,

  ➢ But what are the implications and best responses?

• In particular with the perspective of financial stability, we should
  ➢ Focus more on the dynamically changing structure of these markets
  ➢ Not only on the stocks held by investors,
  ➢ But also who predominates turnovers (hedge funds, low stocks, but around 40 % of turnovers in some EMEs) ….
IV. French G20 presidency and further challenges
French G20 Presidency supports local currency bond market development

- Very welcome that the French G20 Presidency broadens the political support for developing local currency bond markets

- LCBM could play an important role for stabilising the International Monetary System

- Facilitate the Management of Capital Flows; diversifying financial systems and shock absorbing capacities

- Worldwide high interest in developing local currency bond markets

- Nevertheless, political support by G20, can enhance, inter alia, broadening the data base

- … and technical assistance, in particular for developing countries